0000040067

31EX

RECEIVED

2006 JAN 30 P 4: 03

AZ CORP COMMISSION
DOCUMENT CONTROL

Transcript Exhibit(s)

Docket #(s): E-01345A-03-0437

E-01345A-05-0526

E-01345A-06-0009

Exhibit # : APS-1, APS-2, APS3, APS4, Mayes 1, Mundell 1

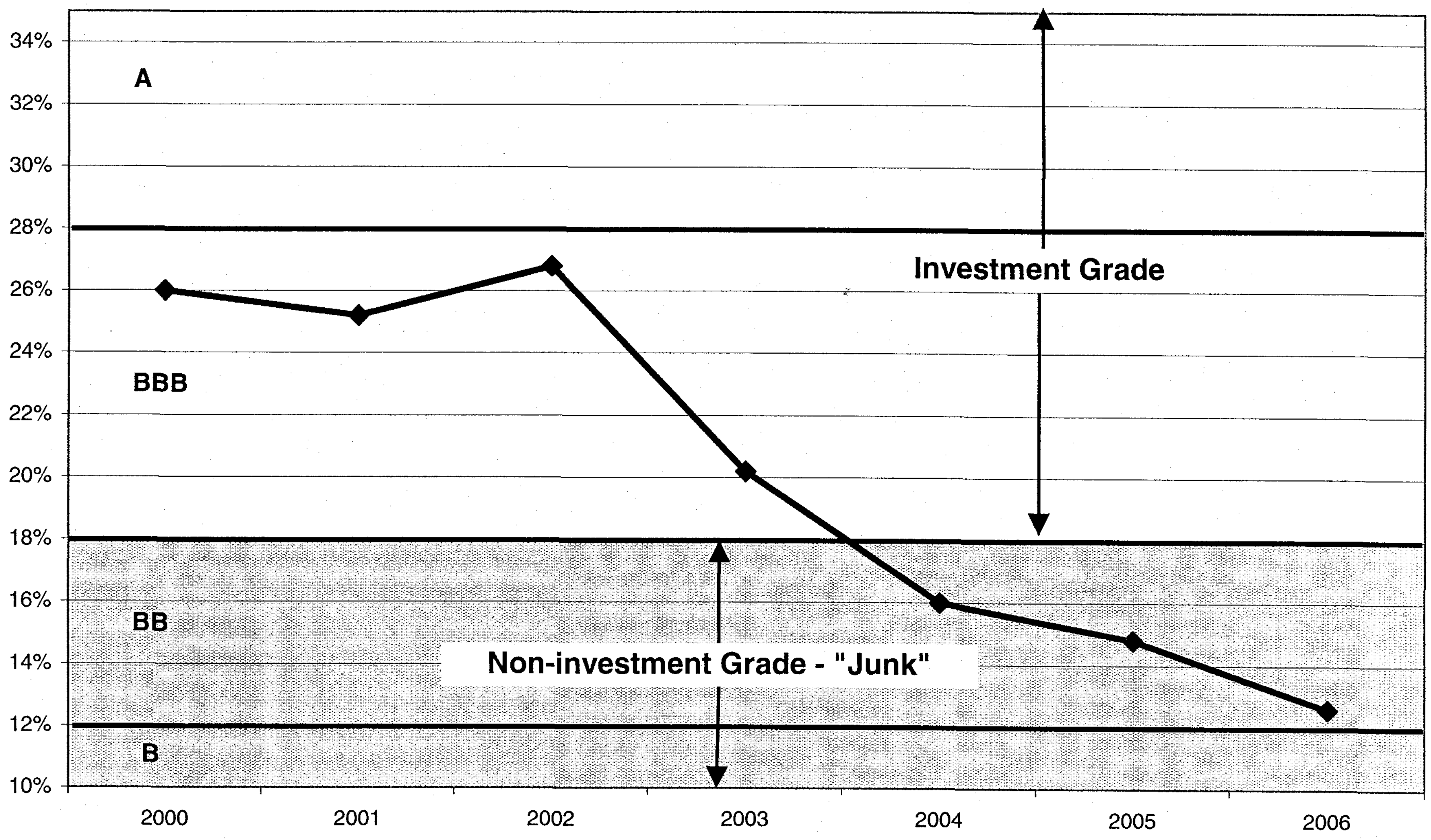
Arizona Corporation Commission
DOCKETED

JAN 3 0 2006

DOCKETED BY

APS Exhibit # 1

Arizona Public Service Company
Ratio of Funds from Operations to Debt*
(No Interim Rate Increase and No Surcharge or PSA Adjustor)

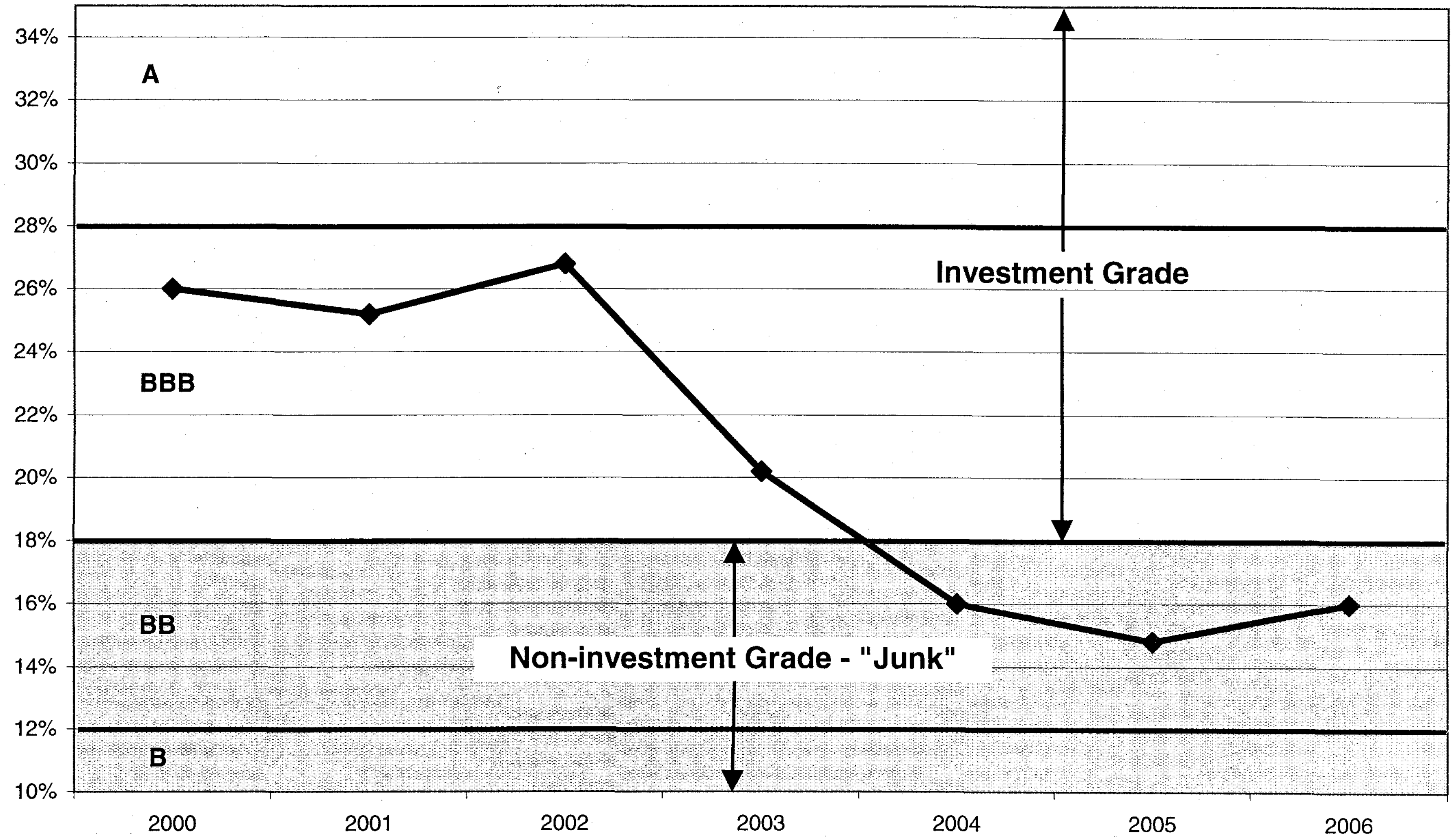


* Key financial ratio used by the credit rating agencies (Standard & Poors and Moody's) to measure cash flow available to service debt

APS Exhibit #2

EXHIBIT
APS-2
Admitted

Arizona Public Service Company
Ratio of Funds from Operations to Debt*
(No Interim Rate Increase - Surcharge and PSA Adjustor only)

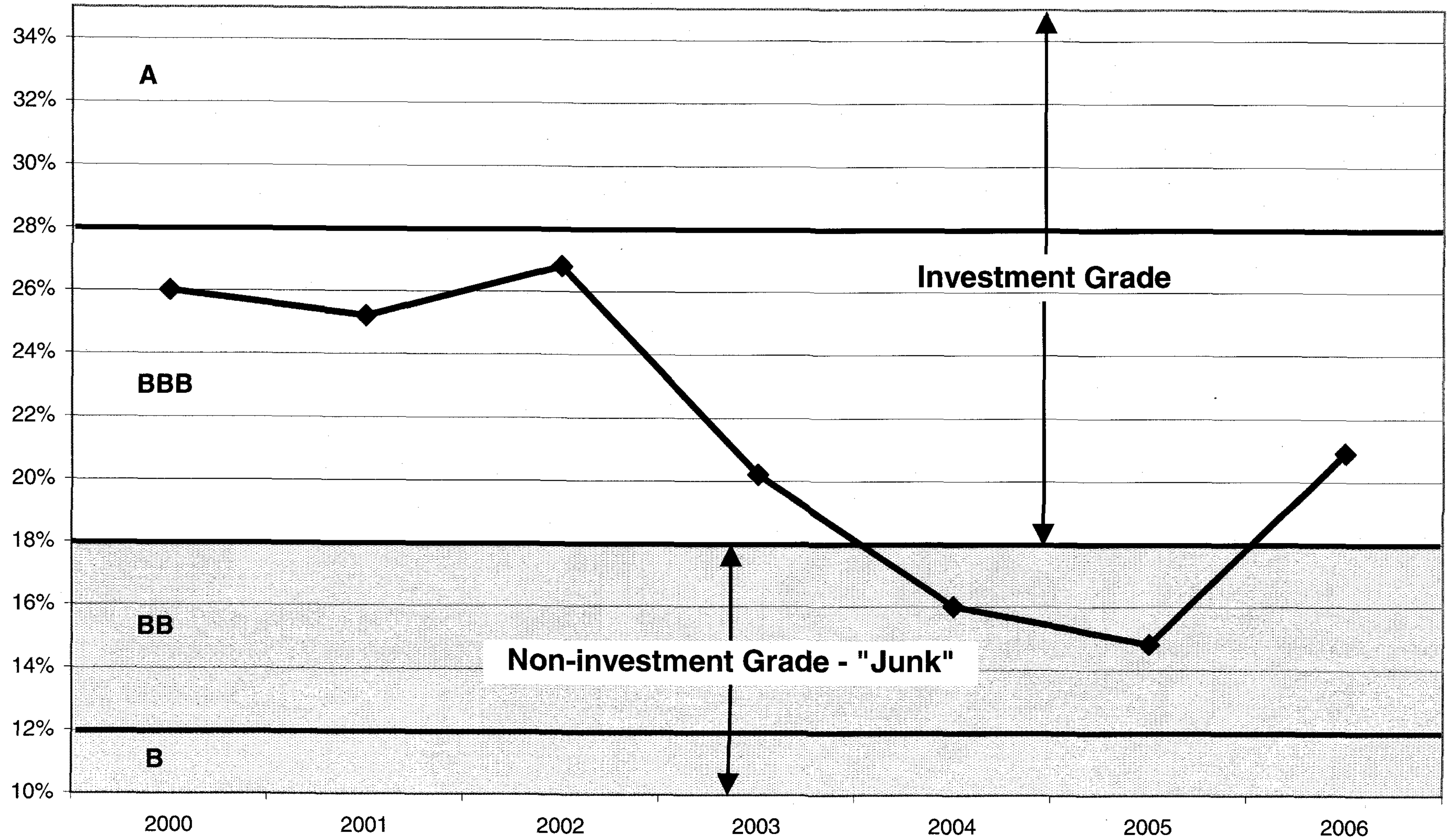


* Key financial ratio used by the credit rating agencies (Standard & Poors and Moody's) to measure cash flow available to service debt

APS - 3

EXHIBIT
APS - 3
Admitted

Arizona Public Service Company
Ratio of Funds from Operations to Debt*
(Interim Rate Increase, Surcharge, and PSA Adjustor)



* Key financial ratio used by the credit rating agencies (Standard & Poors and Moody's) to measure cash flow available to service debt

APS-4

EXHIBIT
APS-4
Admitted

RESEARCH

Credit FAQ: Credit Issues Expected To Continue For Pinnacle West Capital Corp. And Arizona Public Service Co.

Publication date: 24-Jan-2006
Primary Credit Analyst: Anne Selting, San Francisco (1) 415-371-5009; anne_selting@standardandpoors.com

On Dec. 21, 2005, Standard & Poor's Ratings Services lowered the corporate credit ratings on Arizona Public Service Co. (APS) and its parent, Pinnacle West Capital Corp. (PWCC) by one notch to 'BBB-'. This action reflected three factors: growing fuel and purchased power deferrals, which are weakening financial performance in 2005 and 2006, the lack of action by the Arizona Corporation Commission (ACC) in 2005 to address a portion of these deferrals through a special surcharge, and the likelihood of delays in the completion of APS' recent general rate case (GRC) filing, which suggest that financial weakening may extend into 2007.

Standard & Poor's stated at the time that any adverse regulatory developments or continued delays in resolving the pending surcharge request could trigger another rating action, which could include a revision of the stable rating outlook to negative, placing the company's debt rating on CreditWatch with negative implications, or lowering the rating to non-investment grade.

Frequently Asked Questions

How large are APS' deferrals of fuel and purchased power?

At Jan. 31, 2006, APS' estimated fuel and purchased power deferrals are expected to be about $165 million. These deferrals are accumulating because APS' base electric rates are set to reflect 2003 costs, and power and natural gas costs have far exceeded these rates. APS collects 2.0473 cents per kilowatt-hour (kWh) in rates for these costs, but for the 12 months ended September 2005, its actual cost averaged 2.701 cents per kWh. Because these rates will not be updated until the completion of APS' recently filed GRC or the emergency interim request, deferrals will likely continue to accumulate in 2006 and into 2007.

The amount by which 2006 actual fuel and purchased power costs will exceed the authorized expenditures will be a function of retail sales growth, commodity costs, the operational performance of APS' generation assets, and the fuel-in-base factor. Standard & Poor's has estimated that, at year-end 2006, the utility will likely incur an additional $250 million in fuel and purchased power costs that are not recoverable in base electric rates. The sum of balances to date of $165 million plus the expected incremental deferrals of $250 million total $415 million; however, because APS has the potential to collect some of its 2005 balances through a power supply adjuster (PSA) beginning April 1, year-end 2006 deferrals on the utility's balance sheet will not reach that level.

What are the ways that APS could recover its expected deferrals?

Under the terms of a settlement reached in APS' 2003 rate case approved by the ACC in April 2005, the PSA may be increased as much as four mills per kWh (a cap over the life of the PSA) on April 1, 2006. Using 2005 retail sales, and assuming a 4.5% growth rate (which is consistent with recent results), the four mills should yield about $125 million in rate relief on an annualized basis, or about $83 million for the eight months of 2006. Thus, as a rough approximation, APS' deferred balance would be about $330 million at year-end 2006.

On Jan. 17, the chairman of the ACC introduced a proposal to accelerate the PSA adjustment to Feb. 1. If this were approved by the ACC, an additional two months of the PSA would provide about $20 million in incremental revenues (e.g., roughly $125 million multiplied by two-twelfths of the year) in 2006. Thus, if the Hatch-Miller amendment moves forward, year-end 2006 deferred balances will be closer to about $310 million. The amendment is expected to be discussed on Jan. 24.

Additional relief could be provided if the ACC grants APS' request to recover $80 million by means of a two-year special surcharge that would increase retail rates by about 2%. On Jan. 4, an administrative law judge issued a decision indicating that APS' surcharge application is premature until the company's first power supply adjustment occurs in April. An ACC vote is scheduled for Jan. 24. Standard & Poor's current assumption is that the surcharge will be approved by the ACC, but will be delayed until July 1, 2006. A surcharge implemented at this time would provide roughly an additional $20 million to the company in 2006. If it were implemented sooner, the impact on deferrals would be relatively small, providing about $3 million in each month it is in place during 2006. If the Hatch-Miller amendment were approved and a surcharge was implemented and approved for Feb. 1, the two measures collectively would bring between $50 million-$57 million in relief. Accordingly, relative to the year-end expected balances, an accelerated surcharge and PSA, if granted, will reduce deferrals but only by about 20% in the best-case scenario.

What is the status with APS' emergency interim filing?
On Jan. 6, 2006, APS filed a $299 million request for emergency fuel and purchased power-related rate relief. Any amounts, if granted, would be subject to future prudency review. As part of a procedural conference on Jan. 12, four of the five commissioners questioned the definition an emergency and whether relief is justified. Based on the strong views expressed, it appears unlikely that the filing has support. On Jan. 19, a procedural schedule was set that should allow for a decision in April 2006. Standard & Poor's forecast estimates do not assume emergency relief is granted.

Are there credit concerns related to APS' rate cap?
Balancing these potential sources of rate relief are additional adverse financial effects that could occur for APS if its "hard cap" of $776 million is not lifted. The cap is part of APS' 2004 settlement, approved by the ACC in April 2005, which restricts the total amount of annual fuel and purchased power costs that can be collected in retail rates. APS expects that its fuel and purchased power costs will exceed the cap in the fourth quarter of 2006, and has indicated publicly that its estimated fuel costs will exceed $800 million. As part of its emergency interim filing, APS has requested that the cap be removed. If the cap is not lifted, any amounts above $776 million would be unrecoverable, putting further pressure on cash flows.

What assumptions does Standard & Poor's make about the performance of APS' generation assets in estimating deferred balances?
Standard & Poor's estimates assume normal operational performance of APS' generation fleet. Forced outages could increase deferred balances. Palo Verde unit 1 is in the process of exiting an outage that occurred last week due to pipe vibrations within the emergency cooling system. APS took the unit offline last week to install clamps in an effort to stop the excess vibrations. From late December until Jan. 17, unit 1 has operated at about 30% capacity while crews have tried to fix the problem, which followed the completion of the unit's exit from a refueling and maintenance outage begun in the fall of 2005. The plant is expected to maintain approximately this level of reduced capacity while additional repairs are considered. Replacement power costs have been incurred in association with this last outage, and could build, depending on the timeline for a solution to be implemented. These and any future costs are not part of Standard & Poor's deferred estimates.

How are these estimated deferrals expected to affect 2005 and 2006 financial performance, especially in the context of the credit benchmarks at the 'BBB-' rating?
Year-end results for 2005 are not yet available, but Standard & Poor's expects that 2005 and 2006 results will be on par with the 12 months ending Sept. 30, 2005, when consolidated adjusted funds from operations (FFO) to total debt was 14.8%. FFO to total debt is an important metric for Standard & Poor's, and at a business profile of '6' (on a 10-point scale where '1' is excellent and '10' vulnerable), it reflects a below-investment-grade performance. For the 12 months ending Sept. 30, 2005, FFO interest coverage was 3.3x, which is reasonable for the current rating. Adjusted total debt to total capitalization was 53.1%, and is solid for the current rating.

Performance in 2007 will be heavily dependent on when the GRC is resolved. APS filed on Nov. 4, 2005, for a $409.1 million (or 19.9%) rate increase, the majority of which is related to fuel and purchased power costs. Typically, the ACC certifies the application as complete within 30 days, and the case commences. But in early December 2005, the ACC requested that the company re-file its application using a test year ending Sept. 30, 2005, rather than the Dec. 31, 2004 data that APS used. The updated application is expected to be re-submitted to the ACC on Jan. 31, 2005.

As a result, the case will not begin until early March 2006, suggesting that an outcome will be delayed roughly three months from the original schedule, which envisions a ruling by early 2007. Recent public statements by the ACC indicate that spring 2007 may be the earliest a decision could be expected. But there is little precedent in Arizona that would suggest a year-long rate case is likely. A more conservative estimate would assume mid-2007. This could be a credit concern because if permanent rate relief is not in place prior to the peak summer season, financial recovery could also be stalled in 2007.

How is the company's liquidity?

Unaudited consolidated cash and investments stood at roughly $150 million as of Dec. 31, 2005. PWCC and APS also maintain a total of $700 million in revolving credit facilities, which had approximately $15 million of usage at year-end 2005 for miscellaneous letters of credit. Standard & Poor's preliminary assessment is that the company's credit lines should be sufficient to support working capital needs, purchases of gas and power, as well as fund margining and collateral requirements for trading operations. As of Dec. 31, 2005, PWCC and APS comfortably met their loan covenant requirements.

PWCC has a $300 million dollar maturity on April 1, which it plans to refinance. Adverse regulatory actions could affect the costs of borrowing or even access to the capital markets, although this is not currently seen as a significant threat.

APS' reliance on purchases and gas-fired peaking capacity during the winter is low; however, this is seasonal. Fuel and purchased power expenses are anticipated to be accrued faster in July 2006 through September 2006. Standard & Poor's is conducting a more detailed liquidity assessment, which will be completed once more clarity is provided on how the ACC is expected to address interim rate relief requests. APS has a significant hedging program and 85% of its 2006 power and gas requirements are hedged. APS and PWCC are currently holding counterparties' collateral as a result of their in-the-money hedged positions.

Could cost saving measures, or the sale of nonregulated assets by PWCC assist in restoring credit quality?

The ACC has requested that the company explain what cost reductions it is making to compensate for the fact that its retail rates are not aligned with production costs. In response, the company cancelled bonuses for its corporate officers, and is certain to investigate additional cost-savings measures. While these actions may address other public policy issues of concern to the ACC, from a credit standpoint cost cutting measures are unlikely to materially alleviate APS' sagging financial performance.

The deferred balances stem from fuel and purchased power costs that the utility incurred to serve retail loads. APS earns no margin on these expenses; they are simply passed straight through to customers. Similar to the circumstances that other western utilities have faced in recent years, APS' fuel and purchased costs substantially exceed the amount currently recoverable in rates. The company may be able to temporarily subsidize the cost of serving retail loads by reducing expenses in other parts of the company, selling other PWCC assets, or issuing debt, but such a strategy is not sustainable, and could very well result in longer-term adverse consequences for the company.

Mayes-1

EXHIBIT

MAYES-1

Admitted

Arizona Public Service Company
PSA Deferral Balance Components
at 11/30/05 Market Prices
millions of $

PSA Balance as of 11/30/05		$ 159
Projected December 2005 deferral		$ 5
Projected PSA Balance as of 12/31/05		**$ 164**
2006 Activity		
Fuel & Purchased Power Deferral		
Below $776M Fuel Cost	178	
Above $776M Fuel Cost	65	
2006 Deferral		243
Interest		9
12/31/06 Balance before Recovery		**$ 416**
Revenues		
Current Surcharge Filing ($80M - 2/06 start)	37	
Surcharge #2 ($100M - 11/06 start)	7	
Annual Adjustment (.3976 ¢/kWh)	88	
2006 Revenues		132
Projected PSA Balance as of 12/31/06		**$ 285**

Return to Regular Format

Research:

Research Update: Pinnacle West Capital's, Arizona Public Service's Ratings Lowered To 'BBB-'; Outlook Stable

Publication date: 21-Dec-2005
Primary Credit Analyst: Anne Selting, San Francisco (1) 415-371-5009; anne_selting@standardandpoors.com

Credit Rating: BBB-/Stable/A-3

Rationale

On Dec. 21, 2005, Standard & Poor's Ratings Services lowered its corporate credit ratings on Pinnacle West Capital Corp. (PWCC) and principal electric utility subsidiary Arizona Public Service Co. (APS) to 'BBB-' from 'BBB'. The outlook is stable.

This action is based on increased regulatory and operating risk at APS. Specifically, Standard & Poor's is concerned that the Arizona Corporation Commission (ACC) is not expeditiously addressing APS' growing fuel and purchased-power cost deferrals, which have grown much more rapidly than expected in 2005, particularly because of elevated gas prices and the utility's increased dependence on this fuel. In November 2005, APS filed for a nearly 20% increase in customer electric rates, but it appears unlikely that a resolution will be reached until 2007, and may be delayed to mid-2007. Combined with a year of weaker-than-expected performance at the historically reliable Palo Verde nuclear station, Standard & Poor's now views the business profile of PWCC and APS as a satisfactory '6' (on a 10-point scale where '1' is excellent) and no longer a '5'.

APS's fuel and purchased-power cost deferrals were nearly $150 million as of Sept. 30, 2005. Because the ACC has not acted on the utility's request to recover a portion of this amount in a surcharge, this entire balance, and any new additions through Dec. 31 will be carried into 2006. Standard & Poor's estimates that the utility may incur an additional $265 million in deferral balances by year-end 2006. Actual balances will be a function of how the ACC addresses existing amounts, as well as forward market prices and the company's hedged positions. To date, APS has hedged about 85% of its purchased power and natural gas fuel price risk for its retail load in 2006 and 65% in 2007.

A surcharge proceeding that would resolve $80 million of the utility's current deferrals has been before the commission for five months. The surcharge process was mandated by the ACC as part of the settlement of APS's 2003 rate case that it approved in March 2005. APS is required to notify the ACC when its fuel and purchased-power deferrals reach $50 million and to file a plan for recovery before deferrals exceed $100 million. In July 2005, the utility filed an application to recover about $100 million through a two-year surcharge, but reduced it to $80 million to exclude Palo Verde outage related costs, which will be addressed in a later proceeding. If approved, residential rates would increase about 1.6%.

Since the fall of 2005, Standard & Poor's has conditioned a stable outlook on the satisfactory resolution of this portion of deferrals before year-end. Yet, because of the sustained increase in deferrals, even if the surcharge is implemented, it will likely resolve only about one-half of the company's expected deferred balances at year-end 2005.

Beyond the surcharge, additional 2005 deferred balances can be addressed through an adjustment to the company's power supply adjuster (PSA). However, the PSA has several limitations. It allows APS to collect

90% of the difference between actual fuel, purchased power, and associated hedging costs and those reflected in retail rates. But as per the settlement, APS may not be granted an adjustment before April 2006. Until then the PSA is set at zero. This is problematic because retail rates reflect fuel and purchased-power costs based on 2003 costs when the price of natural gas averaged about $5.50 per million BTU. In addition to a certain wait of four months for PSA adjustments to be authorized, upward adjustments are capped at 4 mils per kilowatt-hours for the life of the mechanism. As a result, all or nearly all of the PSA capacity is likely to be absorbed in APS's first PSA filing, and the utility is expected to end the summer of 2006 needing another surcharge to address additional balances that will accumulate. Thus, any rate relief granted for remaining 2005 deferrals will not completely resolve the issue because the onset of the utility's summer cooling season in late April will contribute additional amounts to deferred balances.

APS's new general rate case request totals $409.1 million (19.9%) increase in annual revenues. About $247 million of the request is related to increased fuel and purchased-power costs. Recent public statements by the ACC suggest spring 2007 may be the earliest a decision could be expected. APS's last rate case took nearly 23 months to conclude, and there is therefore substantial uncertainty as to when the case will be completed.

An additional factor contributing to PWCC's weakened business profile is the performance of the Palo Verde nuclear units in 2005. The three-unit facility typically supplies 25% to 30% of the utility's energy requirements. In 2005, the combined capacity factor for the three units is expected to be about 78%, against the company's forecast of 86%. While some of the deterioration reflects the expected increase in Unit 1's refueling outage to 75 days from 33 days, enabling the replacement of the unit's steam turbine generators, the units have been beset by a series of operational problems, which include an overhang of issues first raised by the NRC in 2004. Specifically, in the summer of 2004, the company identified piping in a portion of the emergency cooling system that was dry, a situation that the NRC flagged as "yellow," the second-most serious of four categories of violations.

The yellow flag triggered onsite NRC inspections in the fall of 2005. On Oct. 11, 2005, Units 2 and 3 were taken off line after NRC officials posed questions as to how the emergency cooling systems might operate under a range of hypothetical scenarios. The plants were brought back into service 10 days later, after the company successfully demonstrated that the cooling systems would operate as designed. An NRC inspection report related to the cooling system issues is expected in December 2005. Other operational problems have also occurred. In the spring of 2005, problems with the pressurizer heating elements in Unit 3 resulted in the extension of a planned 10-day outage to 32 days. In September, APS announced that day-to-day management of Palo Verde has been reorganized.

PWCC's consolidated cash coverage metrics are expected to be largely in line with 2004 results, which were very weak due to APS's delayed rate relief. For the 12 months ending Sept. 30, adjusted funds from operations (FFO) to interest coverage was 3.3x, identical to coverage at the end of 2004. The 12-month adjusted FFO to total debt was 14.8%, and reflects about $80 million in cash flows from Suncor assets sales that will not be realized in 2006 at this level. Future cash flow metrics will depend significantly on the ACC's actions, but are generally not expected to display any significant improvement through 2006 due to a continued build up of deferrals. Performance in 2007 will be heavily predicated on how long it takes for the ACC to rule on the company's base rate increase. Due in large part to PWCC's April 2005 issuance of $250 million in common stock, adjusted debt to total capitalization remains solid at 53% . However, borrowing requirements could rise in 2006 to fund APS's additional power and fuel costs deferrals and to invest in capital expenditures.

Short-term credit factors

PWCC's short-term rating is 'A-3'. The rating is supported by the preponderance of cash flows being produced by APS, a vertically integrated electric utility. Because of APS's sizable commercial paper program, near-term liquidity should be adequate to support cash outlays for power and fuel not recoverable in rates. And, because APS is heading into its winter season, when demand for electricity for space cooling drops significantly, the build-up of its power cost deferrals should slow. APS has hedged most of its power and gas purchases remaining in 2005, 85% of 2006 requirements, and about 65% for 2007.

Consolidated cash and investments stood at more than $900 million as of Sept. 30, 2005. However, $500 million was used on Oct. 3, 2005 to call Pinnacle West Energy Corp.'s (PWEC) floating-rate notes that were due April 2007. Also affecting the cash and invested position is the increased amount of collateral held under bilateral contracts.

PWCC and APS maintain commercial paper programs. Neither program had any balances as of Dec. 20, 2005. PWCC's program is for $250 million and is supported by a five-year, $300 million credit facility that expires in December 2010. The revolver allows PWCC to use up to $100 million of the facility for letters of credit. The revolver has no material adverse change clauses.

APS's short-term rating is also 'A-3'. The rating is supported by the stability of cash flows from regulated operations and good liquidity, although APS will need to continue to rely on borrowings to fund portions of its capital expenditure program, which is expected to be about $800 million in 2005 (and includes $190 million for the purchase of the Sundance power plant), up significantly from $484 million in 2004. APS maintains a $250 million commercial paper program. APS has a five-year, $400 million revolver that expires in December 2010 that supports its commercial paper program, and also provides an additional $150 million for other liquidity needs, including $100 million for letters of credit. The supporting facility has no material adverse change clauses. Consolidated maturities are modest and consist of $384 million in 2006, of which $300 million is a note at the parent, which is due in April. Currently, there are virtually no obligations due in 2007, as PWEC called at par in early October some $500 million in notes that it issued in April 2005 to retire an intercompany loan between PWEC and APS that was associated with the PWEC assets now owned by APS.

Outlook

The stable outlook reflects Standard & Poor's expectation that the ACC will resolve at least a portion of APS's increasing deferred power costs in January 2006. In addition, the outlook presumes that progress will be made in addressing APS' general rate case and that any outcome will support the return of consolidated financial metrics to what until 2004 was a reasonable performance. The stable outlook is also dependent on improved 2006 performance at Palo Verde. Any adverse regulatory development or continued delays in resolving the pending surcharge request could result in a downward revision of the outlook or an adverse rating action. Because no meaningful improvement in the consolidated financial profile is expected in the near term, the potential for positive rating changes does not currently exist.

Ratings List

Ratings Lowered

	To	From
Pinnacle West Capital Corp.		
Corp credit rating	BBB-/Stable/A-3	BBB/Stable/A-2
Senior unsecured debt	BB+	BBB-
Commercial paper	A-3	A-2

Arizona Public Service Co.

Corp credit rating	BBB-/Stable/A-3	BBB/Stable/A-2
Senior unsecured debt	BBB-	BBB
Commercial paper	A-3	A-2

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.